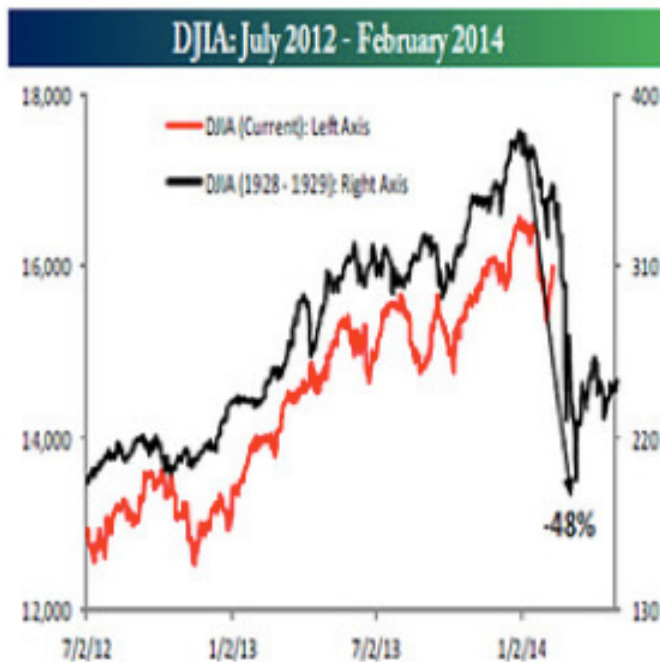
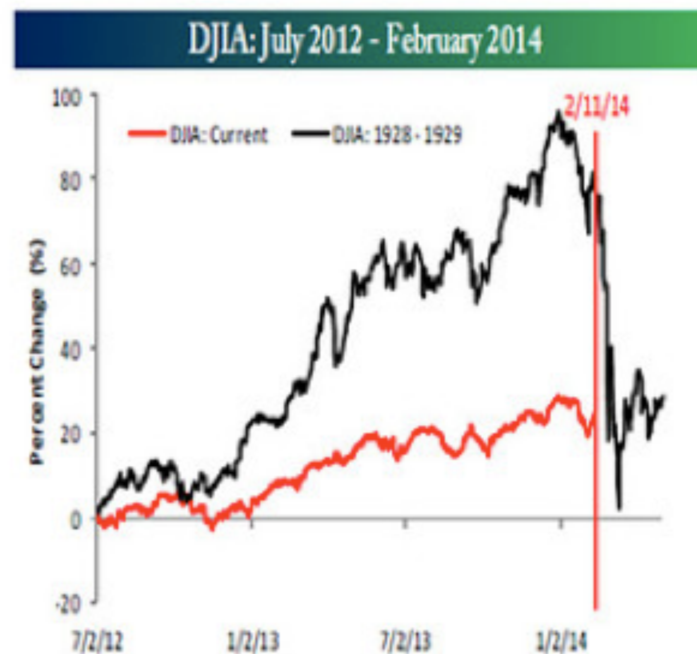
# The Lato Letter – Spring 2014

The perception of the first quarter that was shared with me in casual conversations during the last few weeks was that it was a difficult period for the markets. Well, if that was a difficult period, I will take a quarter like the first quarter of 2014 every time. Maybe people were spoiled by the outstanding year that markets had in 2013, maybe people are slowly starting to forget what really difficult quarters are like as we pass the 5th anniversary of the 2009 market bottom or maybe there is just a healthy wall of worry in the market that augurs well for a continuation of the recovery that started five years ago.

With the technology bubble that started almost fifteen years ago and the housing bubble that led to the financial crisis of 2008 starting a few years later, the general public is constantly looking for that next bubble. The height of the bubble searching began late last year when a chart comparing the US equity market of today to 1929 began making the rounds.



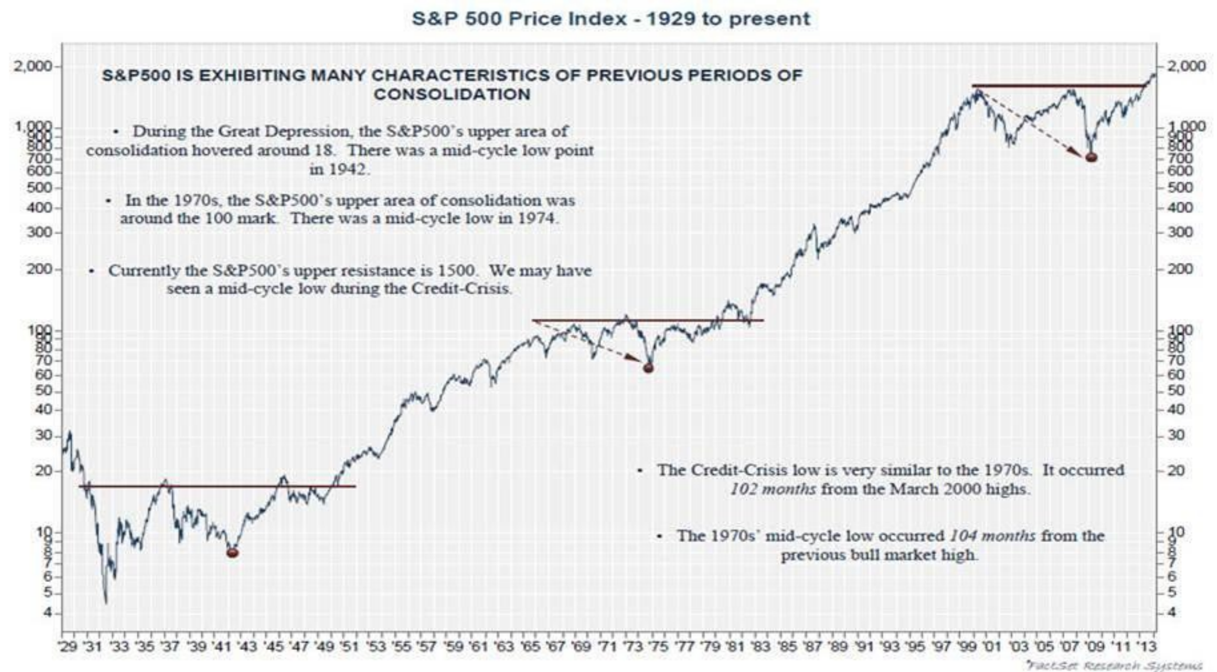



The chart on the left shows the "scary" comparison as it was presented while the chart on the right shows the same data on a percentage return basis and paints a clearly different picture. The best summation that I read of this thesis was penned by Raymond James' market strategist Jeffrey Saut who wrote:

"I have been in this business for over 42 years, yet I do not ever recall getting as slammed with the same email as many times as I have about the attendant 1929 comparison chart. With the S&P 500 now off a mere 1.7% from its all-time high… investors seem exceptionally frightened by this 1929 'scary chart' comparison. Forget about the policy, structural, etc. mistakes that fundamentally caused the Great Depression, which are not present currently, the emotions stirred up by this chart have been amazing to me."

Part of what is driving the search for the next bubble is the fact that as I mentioned earlier, we are now over five years from the market bottom and generally speaking, bull markets start to get a little long in the tooth at that point. There is some validity to that statement but in a much longer term perspective secular changes to markets can last much, much longer even with a classically defined bear market (20% or more correction from the market high) in between.

Once again, borrowing from the fine work of Mr. Saut, this chart shows the S&P 500 Index dating back to the aforementioned late 1920s.




There are five distinct periods captured in the chart. The first period, which is the longest lasting period, starts with the market crash in 1929 which led to the Great Depression followed by World War II. That period was followed by the post-war boom which lasted until the late 1960s. Markets then moved sideways for several years before bottoming in 1974 and essentially provided little or no return to investors until the final bottom for that period in 1982.

I started my career at Wood Gundy in 1980 and having watched the market do nothing but go straight down for two years, I remember being very close to leaving the business before the market turned dramatically upward for essentially the next 18 years. During that time there was also something called “Black Monday” or the “Crash of 87” which occurred on October 19, 1987 and shook all investors to their core. Ironically, that major decline now looks like a tiny blip on the long term chart.

Black Monday included, it was a wonderful period for the markets and certainly brought millions of new investors into the equity markets as this new technology era was just beginning to unfold. As the optimism of the new technology age combined with the tearing down of the Berlin Wall, the optimism turned to euphoria and investors began paying ridiculous multiples for almost any company that had anything to do with technology. Almost fourteen years later, the S&P 500 finally got back to the inflated levels of early 2000 and appears to have broken out from that long digestion period as it did in 1982 and before that in 1951.

I am not suggesting that we will continue onward and upward for the next several years without being concerned about risk but there are many reasons to remain constructive. Those reasons include productivity gains from technological advances, growing prosperity of the global population, strong well capitalized corporations with access to attractive capital and trillions of dollars of potential investment dollars still on the sidelines among them.

There are areas of the market that are behaving euphorically. There are companies such as Netflix, Tesla, Amazon and Facebook to name a few that are great companies with great futures but are simply trading at valuations that are far too rich to be included in Padlock’s portfolios. These companies have been coined the GAAP group; Growth At Any Price and as you know the foundation of Padlock’s methodology is GARP; Growth At a Reasonable Price.

Our GARP portfolios had another good first quarter, outperforming our benchmarks yet still remaining, as a whole, attractively priced given their future growth prospects. There were minimal changes in the portfolios during the quarter which is reflective of that previous statement. There are companies on my watch list but I have not felt compelled to partially or entirely replace the current holdings. That condition could change but as Warren Buffett said; “In this game, the market has to keep pitching, but you don’t have to swing. You can stand there with the bat on your shoulder for six months until you get a fat pitch.”

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